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MARKET OUTLOOK 2024

MORE OF THE SAME

Few investors expected markets to perform as strongly as they did this year. Most of the surprises stemmed from a much more solid US economy, which prevented both a Fed pivot and a recession. What will 2024 bring? More of the same, as we will argue in this Outlook. We no longer expect a US recession, but neither do we agree with the current market view that the Fed will cut rates substantially over the course of the year. What is still the world's most important economy will thus stay on track and markets should advance, though probably at a more moderate pace.

- The global economic cycle should bottom during H1 2024 and turn up, gingerly, thereafter
- Inflation will remain sticky, limiting the room for central banks in many markets to lower rates
- Persistent inflation will support real assets such as equities, while greatly normalized rates support the case for quality bonds as a source of income and a hedge against periods of market weakness
- The end of Fed tightening and the upturn of the global cycle will create further downside for the USD

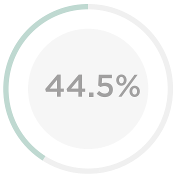
2023 in review: Performance of major asset classes

Assets and Markets			Year-to-date
Equities World		USD	13.9%
	S&P 500	USD	20.3%
	EuroStoxx 50	EUR	20.9%
	FTSE 100	GBP	4.5%
	Swiss Market Index	CHF	5.4%
	Nikkei 225	JPY	27.9%
Equities Emerging Markets		USD	0.4%
	China - CSI 300	USD	-12.8%
	India - SENSEX	INR	16.0%
	Pakistan - KSE-100	PKR	59.8%
USD Investment Grade		USD	3.2%
	US Treasury	USD	2.4%
	US Investment Grade	USD	6.0%
	US High Yield	USD	10.4%
Emerging Market Sov USD		USD	8.3%
Gold		USD	11.5%
Oil (Brent)		USD	-7.1%
USD (trade weighted)		USD	0.3%
	EUR	1.078	0.7%
	GBP	1.258	4.1%
	CHF	0.874	5.8%

Source: Bloomberg as of 7 December 2023

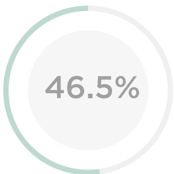
Recommended portfolio allocation for 2024

(Indicative positioning of USD global balanced mandate)



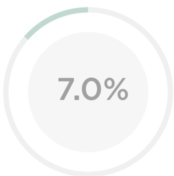
EQUITY

Region/Sector	Allocation
US	24.7%
Europe	3.9%
Japan	0.9%
EM	5.3%
Global	9.7%



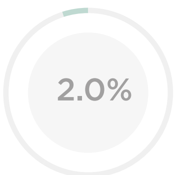
FIXED INCOME

Region/Sector	Allocation
Treasury/ABS	19.0%
Investment Grade	9.0%
Subordinated Bonds	5.5%
High Yield	2.0%
Emerging Markets	11.0%



ALTERNATIVES

Region/Sector	Allocation
Gold	2.0%
Direct Lending/Volatility	5.0%



LIQUIDITY

Region/Sector	Allocation
Cash	2.0%

OUR BASE CASE SCENARIO:
Global cycle to bottom out

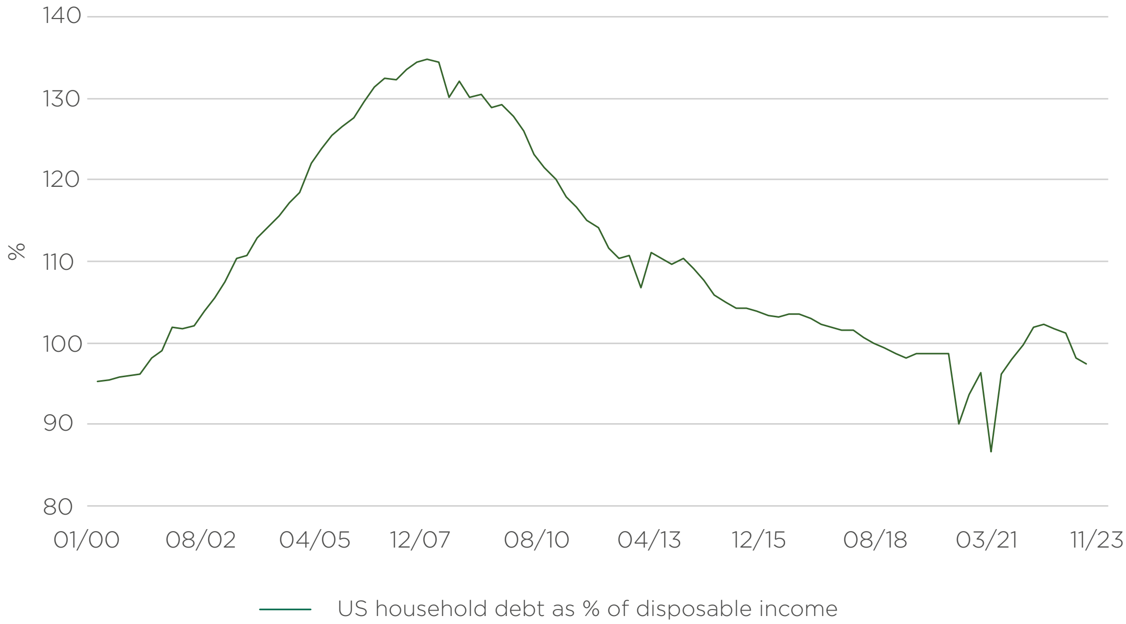
Driver	Comment	Trend	Risk Implications		
			on	neutral	off
Global GDP growth	US to avoid recession, Europe/China to perk up 2H24	→	•		
Global inflation	Inflation to remain above target in many economies	↘	•		
Global policy rates	Terminal rates reached but Fed cuts only 2H24 or later	→		•	
Global liquidity	Declining but central banks to support banking system	↘			•
USD trade-weighted	USD at risk once global turns up	↘	•		

Forecasts for global growth in 2024 are generally lower than for the current year, but the quarterly pattern suggests that the weakness is frontloaded and largely due to a soft spell during the first half of the year. **From mid-year onwards, the global cycle is actually expected to perk up again, as both US and European growth will have bottomed out.** While this upturn will be positive for risk assets and to some extent is already reflected in current market pricing – remember that the stock market is a discounting mechanism – **stronger activity later in the year will also limit the level to which inflation can fall.** Beyond the cyclical elements that drive prices, there are also **structural factors at play that will put a floor under inflation,** namely demographics, with rapid aging in many economies including China, deglobalization or, to put it less negatively, the quest for more resilient supply chains which require significant capital outlays, and decarbonization in the context of climate change, a multitrillion global investment project. The competition for resources will sustain price pressures and limit the ability of central banks to ease their policy setting after almost two years of tightening.

Global: PMI surveys suggest that cyclical bottom is near

Source: Bloomberg, HBZ

US: Households with strong balance sheets



Source: Bloomberg, HBZ

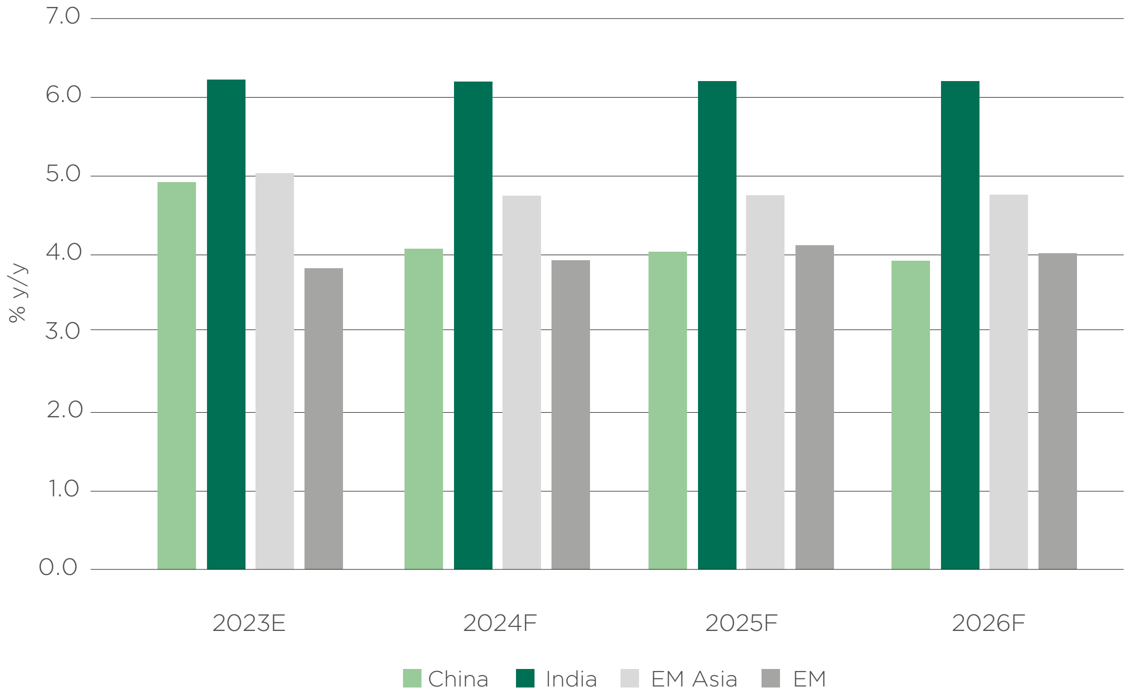
The resilience of the US economy in 2023 has surprised most analysts. While much of the pent-up demand from the pandemic years had been met, a solid job market and robust fiscal spending created conditions for another year of above-trend growth. **Growth will slow in 2024, but probably less than currently forecast.** Labor market conditions should remain supportive, and significant fiscal tightening is unlikely in an election year. Added to this is the often overlooked fact that **households have the strongest balance sheets since the Great Financial Crisis** and, despite 525bps of Fed tightening, debt service as a percentage of disposable income remains close to its multi-decade low. As inflation peaked, **the Fed switched to data-dependent mode,** but currently shows little appetite for cutting rates before inflation is on a clear path to its 2% target. The bar for changes in Fed policy will thus remain high, at least during the first half of the year. The presidential elections, which will be in full swing by the summer, may further complicate matters, as the Fed will not want to be perceived as partisan in its actions.

This year the eurozone skirted a recession, and **the outlook for European economies has not greatly improved.** Many of the factors that held back activity across the continent this year, such as high energy costs, high interest rates, and weak external markets, remain in place. At least inflation has declined materially, and given that growth has also been anemic at best, the **ECB is likely to ease policy by the middle of the year,** followed later by the Bank of England.

Eurozone: ECB to cut on falling inflation, low growth

Source: Bloomberg, HBZ

EM: India the new growth champion



Source: Bloomberg, HBZ

Hopes were high that China's economy would rebound strongly in 2023 after the country's leadership ended all pandemic-related restrictions in a surprise move in late 2022. One year later, there is a sense of disillusion, especially with the slow and very piecemeal response to the ongoing woes of the country's property sector. Given that real estate represents the single largest asset for most Chinese consumers, the collapse of housing demand and prices has weighed on confidence, holding back consumer spending and delaying the transition to a more consumption-led economic model. The deleveraging of real estate also contributed to the return of very low inflation, if not outright deflation. At this juncture, there is no indication that significant additional policy measures will be forthcoming to address these issues and lift activity convincingly. As a result, **analysts expect growth to slow once again in 2024 to around 4.5%** from around 5.0% this year. At the same time, there are signs that external demand has started to pick up, which could boost the external sector. In addition, tension with the US has also been brought down to a more manageable level. However, none of this will stop the politically and economically motivated process of deglobalization, which will force China to reposition its economy and capital markets.

As expected, emerging market (EM) economies outgrew their developed market peers in 2023, although with very large differences between countries. **A similar outperformance in terms of aggregate growth is also expected for 2024, driven mainly by China and India, by far the largest EM economies.** Even at some 4.5%, Chinese growth matters greatly for the global economy, but increasingly India is catching up. India should deliver another year of above-6.0% growth, cementing its place as the fastest-growing major economy as years of reforms and investment start to bear fruit. US-China tensions have strengthened the country's position as a destination for foreign investment, but growth will continue to be driven by the domestic economy. With growth of some 4.6%, EM Asia will remain the fastest-growing region in the world. While the GCC nations will continue to benefit from structural factors and growth-friendly policies, highly indebted EM nations will again be the weakest links, as high interest rates may force more countries to seek debt restructuring. The greatest risks in this regard are located on the African continent.

OUR RISK SCENARIO
A recession after all

Theme/Topic	Comment	Risk Implications		
		on	neutral	off
Growth/inflation	Disinflation stalling well above central bank targets			•
Growth/earnings	Protracted US recession, margin pressures from higher wages, etc.			•
Growth/inflation	Accelerated disinflation allowing for significant monetary easing	•		
Political risk	Escalation in the Middle East, US-China tensions over Taiwan			•

The alternative scenario to "More of the same" is from our vantage point **a recessionary drop in activity centered on the US,** triggered by a credit shock as a result of the dramatic tightening of monetary conditions since March 2022. The credit cycle always looked vulnerable to higher refinancing costs and tighter bank lending standards. In this scenario, US corporates, especially mid and small caps as well as the unlisted SME sector, would struggle to roll over their maturing debt. In turn, the default rate would sharply increase beyond the currently discounted 4-5% for the high-yield market. The ensuing recession need not be particularly long or deep, since the biggest corporates and the banking system will remain robust and well financed, even amid more adverse economic and market conditions. In a recession, inflation should fall towards target quickly, allowing very substantial Fed rate cuts (200-300 bps). Nevertheless, **the rest of the world would not escape unscathed given the importance of the US for market and consumer sentiment and as a destination for exports.** A US recession would reduce marginal demand for imports from key exporting nations around the world. The subdued outlook for China and the still relatively modest per capita income of the Chinese consumer (USD 13,000 vs. USD 76,000 for the US) and the lower import content of the average Chinese consumer basket imply that there is no substitute yet for the US as the world's consumer of last resort. The eurozone, and with it most of the rest of Europe, would follow the US into recession. Similarly, most open EM economies would struggle to decouple from the US cycle. The major outlier should again be India, whose economy remains largely domestically driven. Moreover, in the absence of another, external shock, a period of negative US growth would drive crude oil prices substantially lower, which would help India's external accounts.

INVESTMENT IMPLICATIONS
The return of the multi-asset portfolio

Driver	Comment	Trend	Risk Implications		
			on	neutral	off
Equity valuations	US valuations high but supported by earnings	→		•	
Equity earnings	Earnings growth sustained without a US recession	↗		•	
Credit spreads	IG spreads average, low for high yield	↗		•	

In hindsight, it may well turn out that **2023 was the first important milestone in the great normalization,** i.e., the return to more normal monetary conditions following more than a decade of extreme, not to say excessive, policy accommodation. In most major economies – Japan is the most important outlier – longer-term bond rates are once again aligned with longer-term growth and inflation trends. Policy rates are now above neutral levels; in due course they will fall back again, although it is very unlikely that the zero-bound will be tested again, except possibly in emergency situations such as a 2020-like pandemic shock. Equity valuations, especially in the US, have not yet fully adjusted to their long-term averages, but there are a number of specific factors that support, and in some cases even justify, somewhat higher multiples. A major conclusion from these observations is that **the traditional multi-asset portfolio is alive and well.** Returns between bonds and stocks should decorrelate again in periods of acute market stress, with yields falling along with equity markets. The core assumptions behind portfolio diversification, tested by the sharp and swift policy adjustment between 2022 and 2023, emerged bruised but not broken. Another key lesson for investors is to consider **increasing their exposure to asset classes and strategies with proven abilities to reduce portfolio risks and drawdowns.**

These considerations will most certainly apply to the market conditions likely to prevail if our risk scenario were to become a reality. In particular, bond yields could fall quite dramatically across the curve. Combined with forceful central bank actions in response to a recession, this should lead to a steepening of the yield curve, re-establishing yet another feature of more normal economic conditions.

FIXED INCOME

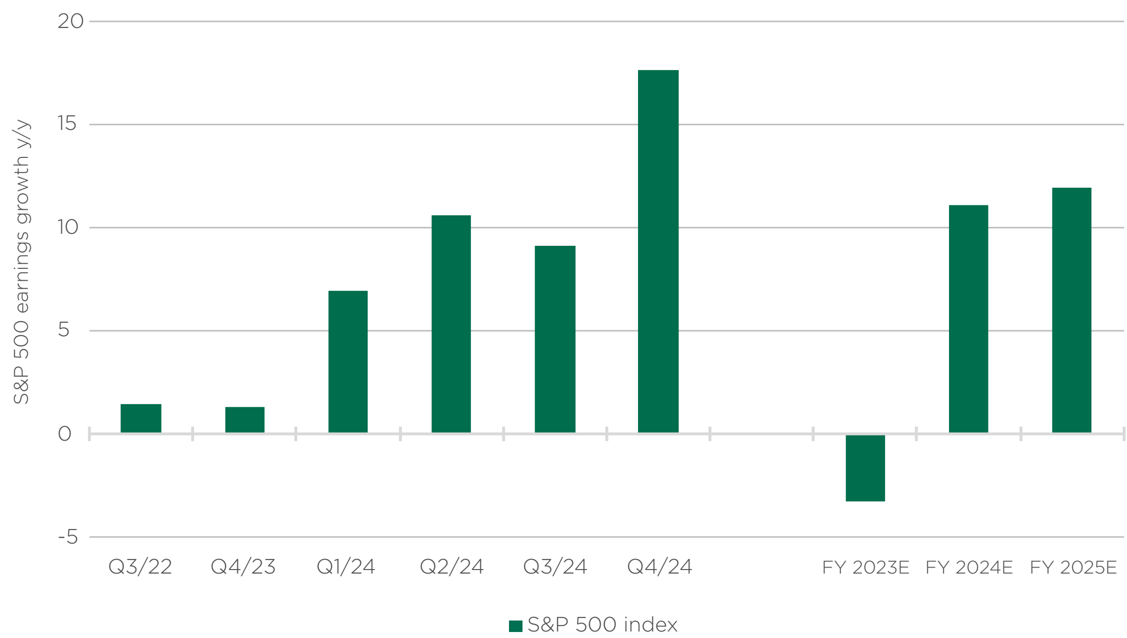
Stick with investment grade and average duration

The great normalization has brought about almost normal market conditions and valuations for **investment-grade corporate bond investors.** Since even in a fair-weather market scenario bond yields will oscillate, at times considerably, investors who remain mostly allocated to money market and short-duration bonds will have **opportunities to move into longer-dated issues to lock in attractive yields for longer.** Subordinated issues, such as corporate hybrid bonds or subordinated bonds of financial issuers, offer additional yield but require the ability to withstand material drawdowns and losses. While spreads of investment-grade issuers are average, those on high-yield bonds are exceedingly tight in most markets, even for our relatively constructive macro backdrop. Many issuers with near-term maturities will face significantly higher refinancing costs, which an increasing number will simply not be able to afford. Higher default rates will be the logical outcome, especially for highly leveraged companies. **Within the emerging-market bond universe, the quality of issuers will also matter, and we continue to favor investment-grade issuers.** EM high yields, both sovereign and corporate, are much less appealing from a risk-adjusted perspective, since the restructuring cycle has not yet peaked.

Bond yields: Back to normal

Source: Bloomberg, HBZ

Equities: Earnings forecast remains robust



Source: Bloomberg, HBZ

EQUITIES
Quality will prevail

Two aspects of this year's stock market performance stand out in particular: **the outsized contribution of the so-called Magnificent Seven stocks to S&P 500 returns, and the ever-increasing weight of the US stock market in the global aggregate.** Since markets tend to be mean reverting, investors are right to wonder how much longer these two factors can prevail. However, there are **currently few indications that a major and protracted reversal could take place in the coming year.** For one thing, in a non-recessionary environment, profits of the largest US corporations should remain robust, not least thanks to their mostly capital-light, cash-flow-heavy business models. Their strong balance sheets and mostly low leverage have actually allowed them to benefit from higher interest rates. In addition, these companies have become global businesses much less reliant on the US cycle alone. So, unless corporate America stumbles, the US domination of the global stock market is unlikely to be challenged.

Nevertheless, **long-term investors should take advantage of the relative neglect of all but the top US stocks and most other regions' markets.** For US-centric portfolios, an equal-weighted allocation to the S&P 500 rather than a market cap approach will protect against weakness of any one of the Magnificent Seven and bring down average valuations to a less demanding level. **Global investors should at some point during the course of the year consider shifting at some point during the course of the year some of their US allocation into cheaper markets** such as Japan, which we favor, the eurozone and, selectively, emerging markets. Within EM, China looks particularly cheap, but maybe for good reason, namely challenging fundamentals, increased political risk, and a leadership largely indifferent to the interest of foreign investors. Unlike China, **India looks decidedly expensive, but Indian companies have the track record to justify higher valuations thanks to steady and high earnings growth.** The fact that many international investors have started to abandon China bodes well for money to flow into the Indian market, which offers the largest number of listed shares anywhere in the world and almost unrivaled opportunities for active management.

In **sector terms, a more balanced allocation is advised,** as some of 2023's laggards should start to benefit from the fact that the macro backdrop remains benign. The one exception should be information technology, despite stretched valuations. IT has become an integral part of any business activity, and will only become more relevant with the **unfolding AI revolution,** which will continue to boost this sector. Healthcare is one of the laggards poised to recover once the global cycle turns up, but this also includes more cyclical sectors such as industrials.

CURRENCIES & COMMODITIES

USD vulnerability increasing

The US dollar is and will remain the dominant global currency. However, this status alone will not protect it from a long overdue and significant correction, postponed for now by the uncanny resilience of the US cycle. Once the Fed has ended its tightening and the global cycle turns up, the tepid weakening since late 2022 could turn into a rout. Only time will tell whether this will start in 2024 or will be pushed into 2025. The latter could well be the case if the ECB and the Bank of England start easing ahead of the Fed as we currently expect. The fortunes of EM currencies will depend similarly on their domestic dynamics and more generally more favorable investor sentiment. However, the attractive risk-free rates for most G10 currencies reduce the appeal of many EM currencies on a risk-adjusted basis.

Among major commodities, **gold came into its own in 2023 thanks among other things to its currency-like properties, as investors sought diversification away from the USD. This trend should continue in 2024,** aided by central banks seeking a reserve asset that cannot be frozen internationally. Gold also remains our preferred hedge against US weakness, notwithstanding the metal's negative carry. This year crude oil again went through all kinds of ups and downs. Going into 2024, the only forecast we can make with some degree of conviction is that oil **will offer opportunities as a trading asset to monetize its volatility.** Saudi Arabia is seeking to regain control over the global oil market and may surprise at some stage with higher rather than lower production to drive out unwanted non-OPEC competition.

PRIVATE MARKETS
Under certain conditions

Private market investments such as private equity and private credit have been a boon for institutional investors since well before the arrival of ultra-low policy rates in 2009. Over time, more and more private investors have sought access to this asset class, which offers low correlation and superior returns. Today, the **democratization of private markets is in full swing.** However, with very respectable returns once again available on traditional highly liquid quality fixed-income assets, investors also need to consider the drawbacks of such investments, including long lock-up periods and only marginal liquidity at unfavorable conditions. **For large portfolios with well-understood liquidity profiles and long investment horizons, a meaningful allocation can make eminent sense.** In this context, however, manager selection is key, and will determine whether current vintages and deals that on paper offer more attractive valuations will in the end deliver the anticipated returns.

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